

JPM-pp1

Asia Pacific Equity Research

25 March 2015

Bank of China - H (3988 HK)

Overweight

Price: HK\$4.40

25 Mar 2015

Price Target: HK\$5.00

PT End Date: 31 Dec 2015

FY14 results - contraction on DPS is a downside surprise

BOC reported FY14 net profits of RMB169.6bn, up 8% YoY. This was 1% higher than JPM and Bloomberg estimates. The major disappointment is that dividend payout ratio was cut to 33% from 35% in FY13, and dividend per share of RMB0.19 was 3% lower than previous year DPS of RMB0.196. Other than that, there was no major surprise on key earnings trends. NIM slightly contracted by 2bps qoq, and NPL ratio went up by 11bps qoq. This was broadly in line with industry trend. BOC's dividend payout ratio of 33% was the same as that of ABC's, despite that BOC has a stronger capital position than ABC (BOC core tier 1 ratio of 10.61% vs ABC of 9.09% at end 2014). The read-across is that ICBC and CCB are likely to cut their dividend payout ratio to 33% despite a strong capital position.

What we like about the results?

- **Improving profitability for overseas business:** Overseas business contributed 23% of profits before tax (PBT) in 2014, up from 19% in 2013. Pre-provisional profits (PPoP) and PBT from overseas operation increased by 31% YoY and 30% YoY, respectively, in 2014; significantly higher than domestic PPoP of 16% YoY and PBT of 4% YoY. PBT/average assets, excluding impact of exchange difference, increased by 8bps YoY to 1.26% in 2014; the trend is better than domestic business which saw PBT/average assets decline by 7bps YoY.
- **Capital position is strengthened:** Core capital ratio and tier 1 ratio went up by 10bps and 83bps qoq to 10.61% and 11.35%, respectively. We calculate that core tier 1 ratio and tier 1 ratio will be strengthened by another 15bps due to CB conversion of RMB15bn in 1Q15. In addition, preference shares issuance of RMB28bn in March 2015 may further increase tier 1 capital ratio by ~28bps (but not core tier 1 ratio).
- **Balance sheet liquidity is eased under new regulation on LDR calculation:** Lloan-deposits ratio was reported 72.97% as calculated based on CBRC's revised regulation; it would be 77.9% if calculated based on reported loan and deposits data.
- **Asset quality more stable than peers:** NPL ratio went up by 11bps qoq, largely in line with industry trend of 9bps qoq. Overdue loans went up by 10% HoH in 2H14, better than peers (ABC +35% HoH, CMB +17% HoH and Citic +41% HoH). Special mention loans only went up by 4% HoH, significantly better than industry data of 28% HoH for commercial banks. LGFV loans accounted for 4% of total loan book, with LGFV NPL ratio at 0.10%, significantly lower than BOC's overall NPL ratio of 1.18%. But we noted that NPL coverage ratio declined by 20ppt qoq to 187.6%, the buffer on future earnings against asset quality deterioration is thinner.

What we don't like about the results?

- **First time to see DPS contraction:** Dividend payment was down by 3% YoY to RMB0.19, first time since 2006 (IPO) to see DPS contraction. This was mainly due to two reason: a) dividend payout ratio (RMB55.9 bn/RMB169.6 bn) was cut by 2ppt YoY to 33%; b) BOC's number of shares increased by 3% due to conversion of RMB24.8bn from CB to equity. BOC's reported FY14 DPS of 0.19 was 8% below Bloomberg consensus estimate of RMB0.206. However, after ABC reported a cut of FY14 dividend payout ratio to 33% yesterday, BOC's move may not be a total surprise.
- **NIM was weaker than peers:** 4Q14 NIM was 2.22%, down 2bps qoq. This is slightly worse than industry trend (+2bps qoq) and peers (ABC +8bps qoq, CMB +18bps qoq and Citic +10bps qoq). 4Q14 domestic NIM was 2.46% in 4Q14, flat qoq. We believe that overseas NIM and domestic FX NIM have seen some contraction in 4Q14, resulting in overall NIM contraction of 2bps qoq.

Table 1: Summary of 2014 results

RMB mn	FY13	FY14	YoY	Actual vs JPM				
				FY14E	est	1H14	2H14	HoH
	Actual	Actual		JPM Est.				
NII	283,585	321,102	13%	324,741	-1%	156,675	164,427	5%
Non-Interest Income	123,924	135,226	9%	143,531	-6%	78,197	57,029	-27%
Fees	82,092	91,240	11%	94,878	-4%	52,131	39,109	-25%
Non-fee	41,832	43,986	5%	48,652	-10%	26,066	17,920	-31%
Total Income	407,509	456,328	12%	468,272	-3%	234,872	221,456	-6%
Operating expenses	(172,314)	(177,788)	3%	(182,004)	-2%	(85,897)	(91,891)	7%
Staff costs	(72,762)	(77,889)	7%	(78,474)	-1%	(37,016)	(40,873)	10%
Other operating expenses	(99,552)	(99,899)	0%	(103,530)	-4%	(48,881)	(51,018)	4%
PPoP	235,195	278,540	18%	286,268	-3%	148,975	129,565	-13%
LLP	(22,938)	(46,606)	103%	(57,826)	-19%	(27,502)	(19,104)	-31%
Other Provisions	(572)	(1,775)	210%	(780)	128%	(280)	(1,495)	434%
Pre-Tax	212,777	231,478	9%	228,669	1%	121,950	109,528	-10%
Income Tax	(49,036)	(54,280)	11%	(52,553)	3%	(28,541)	(25,739)	-10%
Attributable Income	156,911	169,595	8%	167,816	1%	89,724	79,871	-11%
Gross Loans	7,607,791	8,483,275	12%	8,665,608	-2%	8,424,595	8,483,275	1%

Deposits	10,097,786	10,885,223	8%	11,302,475	-4%	11,190,569	10,885,223	-3%
Equity	923,916	1,140,859	23%	1,042,807	9%	965,733	1,140,859	18%
Total Assets	13,874,299	15,251,382	10%	15,940,647	-4%	15,469,096	15,251,382	-1%
Key Ratios								
NIM	2.24%	2.25%	1 bps	2.25%	0 bps	2.27%	2.23%	-4 bps
Cost income ratio	42.3%	39.0%	-332 bps	38.9%	9 bps	36.6%	41.5%	492 bps
ROE	17.9%	16.4%	-142 bps	17.0%	-62 bps	19.0%	15.2%	-383 bps
ROA	1.18%	1.16%	-2 bps	1.12%	3 bps	1.22%	1.04%	-18 bps
NPL Ratio	0.96%	1.18%	22 bps	1.17%	1 bps	1.02%	1.18%	17 bps
NPL Coverage ratio	229%	188%	-42 ppt	205%	17 ppt	217%	188%	-29 ppt
Loan loss reserve	2.21%	2.22%	1 bps	2.40%	-18 bps	2.21%	2.22%	1 bps
LDR	75.3%	77.9%	259 bps	76.7%	126 bps	75.3%	77.9%	265 bps
Credit costs	0.30%	0.55%	25 bps	0.67%	-12 bps	0.69%	0.45%	-23 bps
Core capital ratio	9.69%	10.61%	92 bps	10.35%	27 bps	10.11%	10.61%	50 bps
Tier 1 ratio	9.70%	11.35%	165 bps	10.79%	56 bps	10.13%	11.35%	122 bps
CAR	12.46%	13.87%	141 bps	12.70%	118 bps	12.41%	13.87%	146 bps
Dividend payout ratio	35%	33%	-2 ppt	35%	-2 ppt	NA	NA	NA

Source: Company reports, J.P. Morgan estimates.

Table 2: Summary of 4Q14 financials

<i>In Rmb mm unless otherwise stated</i>	4Q13	1Q14	2Q14	3Q14	4Q14	QoQ	YoY
Key P&L Items							
NII	75,380	76,467	80,208	82,100	82,327	0%	9%
Non-Interest Income	26,678	43,427	34,770	29,178	27,851	-5%	4%
Fees	16,707	28,970	23,161	19,947	19,162	-4%	15%
Non-fees	9,971	14,457	11,609	9,231	8,689	-6%	-13%
Total Income	102,058	119,894	114,978	111,278	110,178	-1%	8%
Operating expenses	(46,912)	(44,262)	(41,635)	(43,667)	(48,224)	10%	3%
PPOP	55,146	75,632	73,343	67,611	61,954	-8%	12%
LLP	(4,545)	(15,096)	(12,406)	(11,296)	(7,808)	-31%	72%
Pre-Tax	50,551	60,928	61,022	56,385	53,143	-6%	5%
Income Tax	(12,125)	(13,729)	(14,812)	(12,996)	(12,743)	-2%	5%
Attributable Income	36,701	45,363	44,361	41,409	38,462	-7%	5%
Key Balance Sheet Items							
Gross Loans	7,607,791	8,158,329	8,424,595	8,444,403	8,483,275	0%	12%
Including NPL amount	73,271	80,320	85,860	90,695	100,494	11%	37%
Total deposits	10,097,786	11,014,196	11,190,569	11,047,285	10,885,223	-1%	8%
Total assets	13,874,299	15,105,367	15,469,096	15,427,957	15,251,382	-1%	10%
Equity	923,916	972,542	965,733	1,005,374	1,140,859	13%	23%
Key Ratios							
NIM	2.31%	2.29%	2.25%	2.24%	2.22%	-2bp	-9bp
Cost income ratio	45.97%	36.92%	36.21%	39.24%	43.77%	453bp	-220bp
ROE	16.2%	19.1%	18.3%	16.8%	14.3%	-247bp	-186bp
ROA	1.07%	1.25%	1.16%	1.07%	1.00%	-7bp	-6bp
NPL Ratio	0.96%	0.98%	1.02%	1.07%	1.18%	11bp	22bp
NPL Coverage ratio	229.4%	226.8%	217.0%	207.7%	187.6%	-20 ppt	-42 ppt
Loan loss reserve	2.21%	2.23%	2.21%	2.23%	2.22%	-1bp	1bp
Credit cost	0.24%	0.77%	0.60%	0.54%	0.37%	-17bp	13bp
LDR	75.3%	74.1%	75.3%	76.4%	77.9%	150bp	259bp
Core capital ratio	9.69%	9.58%	10.11%	10.51%	10.61%	10bp	92bp
Tier 1 Ratio	9.70%	9.59%	10.13%	10.52%	11.35%	83bp	165bp
Total CAR	12.46%	12.05%	12.41%	13.07%	13.87%	80bp	141bp
Domestic RMB							
Loans	5,553,630	5,762,508	5,891,705	5,975,261	6,104,014	2%	10%
Deposits	7,688,054	8,445,813	8,431,129	8,236,861	8,120,196	-1%	6%
LDR	72.2%	68.2%	69.9%	72.5%	75.2%	263bp	293bp

Source: Company reports.

Investment Thesis

- More stable NIM than peers', with 17% and 8% of BOC's average interest-earning assets from overseas and domestic FX operations, respectively, in 2013; these assets are not subject to the negative impact from interest rate liberalization in China.
- Lower exposure to areas with high regulatory risks, such as interbank and WMP.
- BOC Group trades at a wide discount (~20%) to the Big 3 SOE banks; in particular, if we strip out BOC HK, BOC's discount is about 30% to other Big 3 SOE banks.
- BOC's dividend yield is the highest among national banks in our coverage. We believe its dividend yield is more resilient than peers', as one way for it to do capital conservation is to maintain the dividend payout level. This is because the strike price of its Rmb40bn convertible bond (CB) is adjusted down with each dividend payout, encouraging a higher conversion rate.
- BOC issued RMB39.94bn of preference shares offshore. BOC announced on 14 May 2014 to issue up to RMB100bn of preference shares, and no more than RMB40bn will be issued offshore. Therefore the issuance is not a surprise to the market. The dividend yield is 6.75%, largely inline with our expectation. We calculated that this will boost its 2015e tier 1 ratio by ~40bps. Return to common equity will decline by ~10bps if we assume no additional leverage post preference shares issuance. However, we expect the BOC will slightly increase its leverage thus the net impacts could be slightly positive. We believe the preference shares issuance is marginally positive to BOC.

Valuation

Our Dec-15 price target of HK\$5.0 is based on DDM using a cost of equity of 13.7%, normalized ROE of 12.5% and terminal date of 31 December 2016.

Risks to Rating and Price Target

- Worse-than-expected asset quality as growth slows in China.
- Worse-than-expected contraction on domestic Rmb NIM amid interest rate de-regulation.
- Regulatory risks on WMP and interbank business.

Banks & Financial Services

AC

Katherine Lei

(852) 2800-8552

katherine.lei@jpmorgan.com

Bloomberg JPMA LEI <GO>

Lu Lu

(852) 2800-8592

lu.lu@jpmorgan.com

Josh Klaczek

(852) 2800-8534

josh.klaczek@jpmorgan.com

J.P. Morgan Securities (Asia Pacific) Limited

www.jpmorganmarkets.com

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Date	Rating	Share Price (HK\$)	Price Target (HK\$)
07-Jan-07	N	4.19	4.80
07-Mar-07	OW	3.66	4.80
07-May-07	OW	3.93	4.60
24-Aug-07	UW	4.09	4.60
04-Oct-07	N	4.29	5.30
31-Oct-07	N	4.93	5.70
13-Jan-08	N	3.58	4.80
26-Feb-08	N	3.28	4.50
29-Apr-08	N	3.89	5.00
06-Jul-08	N	3.43	4.70
29-Aug-08	N	3.32	4.60
29-Oct-08	N	2.02	4.10
04-Mar-09	OW	2.09	4.00
25-Mar-09	OW	2.42	4.10
28-Jun-09	OW	3.68	5.00
28-Aug-09	OW	3.81	5.20
01-Nov-09	OW	4.58	5.70
30-Nov-09	OW	4.13	6.30
10-Mar-10	OW	4.03	5.80
24-Mar-10	OW	4.04	6.10
09-Aug-10	OW	4.23	5.60
27-Aug-10	OW	3.96	5.40
27-Nov-10	N	4.12	5.40
23-Mar-11	N	4.10	5.50
25-Aug-11	N	3.01	5.30
12-Jan-12	N	3.04	5.50
31-Jul-12	N	2.92	3.75
07-Nov-12	N	3.25	4.00
19-Feb-13	N	3.81	4.00
27-Mar-13	N	3.56	4.00
10-Sep-13	N	3.50	4.10
31-Oct-13	N	3.62	4.25
05-Jan-14	OW	3.46	4.35
09-Feb-14	OW	3.22	4.20
26-Jun-14	OW	3.48	4.10
17-Oct-14	OW	3.51	4.30
03-Mar-15	OW	4.49	5.00

<http://gfd-app.emea.jpmchase.net:6080/server/console/chart/?shareClassId=504086&shareClassServerId=4&chartDesignation=1&actionType=C>

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